

8 May 2006

Ms. Susan Bielstein
Technical Director
Financial Accounting Standards Board
401 Merritt 7
P.O. Box 5116
Norwalk, CT 06856-5116

director@fasb.org

**Re: *The Fair Value Option for Financial Assets and Financial Liabilities;
Including an amendment of FASB Statement No. 115***

Dear Ms. Bielstein:

The CFA Centre for Financial Market Integrity (CFA Centre) of CFA Institute,¹ in consultation with its Corporate Disclosure Policy Council (CDPC)², appreciates the opportunity to comment on the Financial Accounting Standards Board's ("FASB") proposal, ***The Fair Value Option for Financial Assets and Financial Liabilities; Including an amendment of FASB Statement No. 115***. The CFA Centre develops, promulgates, and maintains the highest ethical standards for the investment community including the CFA Institute *Code of Ethics* and *Standards of Professional Conduct*. The CFA Centre represents the views of investment professionals to standard setters, regulatory authorities, and legislative bodies worldwide to promote investor protection and efficient global capital markets.

General Comments

The FASB's proposal presents us with a dilemma. We support the FASB in moving towards fair value measurement and convergence with International Financial Reporting Standards. On the other hand, we find it very difficult to accept additional "optionality" for measuring and recognizing financial instruments in the financial statements. The proposed option would permit preparers further discretion to elect when to measure and recognize financial instruments at fair value.

¹ The CFA Centre for Financial Market Integrity is part of CFA Institute®. With headquarters in Charlottesville, VA and regional offices in New York, Hong Kong and London, CFA Institute, formerly the Association for Investment Management and Research®, is a global, non-profit professional association of more than 82,000 financial analysts, portfolio managers, and other investment professionals located in 126 countries of which more than 68,000 are holders of the Chartered Financial Analyst® (CFA®) designation. CFA Institute has 132 affiliated Member Societies and Chapters in 53 countries and territories.

² The objective of the CDPC is to foster the integrity of financial markets through its efforts to address issues affecting the quality of financial reporting and disclosure worldwide. The Council comprises individuals, who are investment professionals with extensive expertise and experience in the global capital markets, as well as CFA Institute member volunteers. In this capacity, the Council provides the practitioners' perspective in the promotion of high-quality financial reporting and disclosures which meet the needs of investors.

Fair Value is the Only Relevant Measurement

Principle 2 of the Centre's paper³ states that *fair value information is the only information relevant for financial decision making*, which is a long-standing view of the Centre. As such, we believe that ***all*** financial assets and financial liabilities should be measured and recognized in the financial statements at fair value with the changes in this value flowing through the income statement.

Financial statements should be useful to those who use them, including investors and other financial decision-makers. Their decisions are very dependent upon the information provided in the financial statements. To enable investors to make well-informed investment decisions, we believe that fair value information provides the most current and relevant measurement of items in these statements. All other bases, including historical cost, sacrifice usefulness and relevance to some other objective, such as convenience, practicality, or unfortunately, a desire to obscure the underlying economics of a business.

As stated in the Centre's comment letter to the IASB, dated 15 March 2005, in response to the Board's proposal to revise the fair value option in IAS 39 –

Our dilemma is exacerbated because we are being asked to express a preference between what we see as two "bad" alternatives: giving issuers the "option" of selecting fair value measurements (FASB proposal and current IAS 39) or curtailing that option (proposed amendments). We neither like giving issuers options nor do we want to curtail the use of fair values in measuring financial instruments. Our conundrum can best be explained as follows:

- (1) We believe that issuers should be required to measure all financial instruments at fair value since it is the most relevant measurement.*
- (2) We adamantly disagree with the notion that issuers will not be able to determine a reliable fair value measurement.*
- (3) We do not believe issuers should have "options" in the recognition and measurement principles used in financial reporting and disclosure.*
- (4) We recognize that political pressures are such that the IASB could not mandate the use of fair value measurements at this time.*

As a basic premise, we believe that a preferred principle can always be found when addressing recognition and measurement in financial statements and that issuers should always be required to use that principle in preparing financial statements. When issuers are presented with options or choices among recognition and measurement principles, investors are always disadvantaged. Either there will be a race to the bottom as issuers use the least

³ A Comprehensive Business Reporting Model: Financial Reporting for Investors – October 2005.

preferred option (from the investor viewpoint) or investors will need to expend their limited resources understanding the various options and restating financial statements where possible. Inconsistency invariably leads to lack of comparability both across issuers and, over time, for a single issuer.

Importance of Adequate Disclosures

Having both quantitative and qualitative information about a company's financial instruments is essential to understanding its financial risks and the exposure to those risks. We view disclosures about financial instruments to be adequate if the following questions can be answered with the information provided in the financial statements, note disclosures and other supplemental information such as management's discussion and analysis:

- What are the financial instruments held by the company?
- What is the company doing with these financial instruments – for what purpose do they hold these instruments? What are its manager's policies and procedures for using certain financial instruments?
- How extensively does the company use these instruments as part of its risk management?
- What are the inherent risks and the exposures to these risks?
- How effective, or ineffective, are the positions in these financial instruments as hedges in managing risk exposure of the company?
- What methods are used to estimate fair value when market values are not readily available?
- What key assumptions are used to calculate these fair values?
- How sensitive are these fair values to certain assumptions, such as changes in interest rates or foreign currency exchange rates?
- What are the effects on operating segments?

With regard to the fair value option, we recommend the following additional disclosures:

1. Disclosures about managers' election and selection policies and procedures, including:
 - a. The type of financial assets and liabilities for which the fair value option is elected;
 - b. Whether all financial assets and liabilities of the same type received the same elective fair value treatment; and

- c. The reason(s) for electing fair value for the specific financial instruments identified.

2. Disclosures about the effects of the election and selection process on the financial statements, including:
 - a. The value of instruments for which fair value was elected;
 - b. Additions to that population during the period;
 - c. Settlements of those instruments during the period;
 - d. The amount of the fair value changes recorded in profit and loss during the period; and
 - e. Where in the income statement (which line item or items) the fair value changes are recorded.

3. The key method(s) and assumptions used to measure fair value by type of transaction for which the fair value option is elected.

Investors and other users of financial statements require this degree of detailed disclosure because individual company valuation is developed, and price multiples are assigned, based upon the values of asset and liability classes in the balance sheet, changes in those values flowing to net income, and the measurement bases of the items. For example, a change of a given amount (in currency units) of cash flows, accruals, or fair values would receive different price multiples. Those items that are measured at fair value, e.g., financial instruments including derivatives, and the resulting gains and losses from changes in the carrying value of financial instruments, will receive significantly different weights and values than for those instruments and other transactions that are not measured at fair value.

Detailed disclosures would also serve to reduce the risk that managers will misuse the fair value option to mislead investors and regulators. When managers are required to both describe the accounting methods used and disclose the financial statement effects of those policies, the resulting transparency makes it possible for investors and regulators to question managers about the underlying transactions and to expose any misuse of the fair value option.

Comments on Issues Identified in the Exposure Draft

Scope

Issue 1: The scope of this proposed Statement includes the following financial assets and financial liabilities that some may not have considered as being included:

- a. An investment being accounted for under the equity method*
- b. Investments in equity securities that do not have readily determinable fair values, as described in paragraph 3 of FASB Statement No. 115, Accounting for Certain Investments in Debt and Equity Securities*
- c. Insurance and reinsurance contracts that are financial instruments, as discussed in FASB Statements No. 60, Accounting and Reporting by Insurance Enterprises, No. 97, Accounting and Reporting by Insurance Enterprises for Certain Long-Duration Contracts and for Realized Gains and Losses from the Sale of Investments, and No. 113, Accounting and Reporting for Reinsurance of Short-Duration and Long-Duration Contracts*
- d. Warranty obligations that are financial liabilities and warranty rights that are financial assets*
- e. Unconditional purchase obligations that are recorded as financial liabilities on the purchaser's statement of financial position as discussed in paragraph 10 of FASB Statement No. 47, Disclosure of Long-Term Obligations.*

Should an entity not be permitted the option to initially and subsequently measure those financial assets and financial liabilities or any others at fair value? If so, why should those financial assets and financial liabilities be excluded from the scope of this proposed Statement?

As noted in our general comments, we do not support measurement options for economically similar financial items and believe that **all** financial instruments should be measured at fair value. In particular, we strongly believe that companies should measure and recognize insurance and reinsurance contracts at fair value. Currently, there is a total mismatch between how invested assets and insurance liabilities are recognized and measured in the financial statements. Assets are generally at fair value and insurance liabilities are measured using historical data, which is locked in unless there is a premium deficiency. This mismatch of valuation diminishes the usefulness of companies' financial statements and in turn, impairs an investor's ability to understand fully the risks, and exposure to those risks, for companies issuing insurance contracts.

To this end, we do not believe any of the above financial items should be excluded from the scope of this Statement provided that there are sufficient quantitative and qualitative disclosures about those financial instruments measured at fair value under this option. These disclosures should provide information about the financial items for which the fair value option is applied, the effect on the

company's financial performance due to the changes in fair value, and the reasons for making such selections. For more elaboration of our view, please refer to our general comments and our response to *Issue 7 – Presentation and Disclosure Requirements*.

Issue 2: This proposed Statement permits an entity to elect the fair value option at inception for a firm commitment that would otherwise not be recognized at inception under existing generally accepted accounting principles (GAAP) and involves only financial instruments.

Should an entity be permitted the option to recognize those firm commitments at fair value at inception of the contract? If so, why is the availability of the fair value option election important for those contracts and what types of entities would likely avail themselves of that fair value option election? Should the scope be limited to forward contracts that meet the definition of firm commitments under FASB Statement No. 133, Accounting for Derivative Instruments and Hedging Activities (that is, requiring that the terms of the forward contract include a disincentive for nonperformance that is sufficiently large to make performance probable)? If not, why not?

Please refer to our response to *Issue 1*. As previously stated, we believe that all financial assets and financial liabilities should be measured at fair value. Moreover, as noted in the Centre's paper, "...all activities that are currently off balance sheet as a result of accounting standards or other conventions must be recognized, including executory contracts. Executory contracts, arrangements for which performance by the various parties is still in progress, represents commitments entered into by a company that will affect shareowners' wealth and should be recognized as any other obligation would be."

Therefore, we believe that the scope should not be limited to forward contracts that meet the definition of firm commitments under FAS 133 because we do not agree with the notion that performance must be *probable* before a commitment should be recognized. This "probable" notion is linked to FASB Statement 5, *Accounting for Contingencies*, which we believe should be amended. (Please refer to our comments on *Issue 5*.) As noted in the Centre's paper, an asset or liability should be recognized when "[t]here is a nonzero probability that the benefit will occur" or "[t]here is a nonzero probability that the obligation will be settled by an outflow of assets, issuance of another liability, or other settlement that will result in a change in the share of net assets available to current shareowners", respectively. This assumes that the other criteria for an asset or liability have also been met.

Issue 3: *The scope of this proposed Statement would exclude both (a) written loan commitments that are not accounted for as derivative instruments under Statement 133 and (b) financial liabilities for demand deposit accounts. The Board decided to specifically exclude those financial instruments, since the determination of their fair values involves consideration of nonfinancial components.*

Should an entity be permitted the fair value option election for those financial instruments? If so, why? What would be the appropriate unit of account for determining the fair value of demand deposit liabilities? What other financial assets and financial liabilities for which their fair values involve consideration of nonfinancial components should be excluded from the scope of this proposed Statement?

Please refer to our responses to *Issue 1* and *Issue 2*. We believe that the proposed Statement should not exclude written loan commitments.

Regarding the scope limitation for demand deposits, we believe in principle that these items should be included within the scope of the proposed Statement. However, the fundamental issue surrounding how to measure demand deposits also affects the valuation of other financial instruments (e.g., insurance contracts) and non-financial items (e.g., internally generated intangibles related to a firm's customer base). Given this broad implication, we support the Board's decision to exclude demand deposits from Phase 1 and to address these items in Phase 2 of the project.

Issue 4: The scope of this proposed Statement would also exclude:

- a) *An investment that would otherwise be consolidated*
- b) *Employers' and plans' financial obligations for pension benefits, other postretirement benefits (including health care and life insurance benefits), postemployment benefits, employee stock option and stock purchase plans, and other forms of deferred compensation arrangements as defined in FASB Statements No. 35, Accounting and Reporting by Defined Benefit Pension Plans, No. 87, Employers' Accounting for Pensions, No. 106, Employers' Accounting for Postretirement Benefits Other Than Pensions, No. 112, Employers' Accounting for Postemployment Benefits, No. 123 (revised December 2004), Share-Based Payment, No. 43, Accounting for Compensated Absences, and No. 146, Accounting for Costs Associated with Exit or Disposal Activities, and APB Opinion No. 12, Omnibus Opinion—1967*
- c) *Financial liabilities recognized under lease contracts as defined in FASB Statement No. 13, Accounting for Leases. (This exclusion does not include a contingent obligation arising out of a cancelled lease or a guarantee of a third-party lease obligation.)*

The Board decided to specifically exclude those financial assets and financial liabilities from the scope of this proposed Statement, as the Board believes that any modifications to the accounting for such financial assets and financial liabilities should be part of a reconsideration of those areas and should not be affected by the fair value option.

Should an entity be permitted the fair value option election for those financial instruments? If so, why?

Please refer to our response to *Issue 1*.

Although, we have a long-standing position that defined benefit plans and *all* leases should be recognized on the balance sheet and measured at fair value, we acknowledge that changes to the accounting for these items should be addressed in a more comprehensive manner. However, we urge the Board to act expeditiously to correct the current accounting standards which permit obligations and the associated costs to be hidden off the financial statements in obscure note disclosures.

Issue 5: As noted above, this proposed Statement represents Phase 1 of the fair value option project. Phase 2 will consider permitting the fair value option for selected nonfinancial assets and liabilities. The Board is seeking input on what nonfinancial instruments should be included in the scope of Phase 2. Please provide details of those nonfinancial instruments and why they should be eligible for the fair value option.

How would applying the fair value option to those nonfinancial instruments (a) improve financial reporting, (b) mitigate problems for reported earnings caused by the mixed-attribute model, and (c) enable an entity to simplify its accounting methods? Is fair value information readily available for those nonfinancial instruments?

We believe that the measurement and recognition of both financial and nonfinancial instruments should reflect current market and other relevant data rather than a measurement which reflects a historical perspective. As noted previously, we believe fair value measurements provide the most useful and relevant information for investors. As such, we do not support measurement alternatives because fair value measurement should not be an option.

FASB Statement 5 needs to be amended. Too often contingencies are not recognized in a timely manner and are maintained off the balance sheet. However, we believe that these nonfinancial items should be addressed in a different project and not within Phase 2 of this project. We do not believe that permitting companies to elect fair value for these items will correct or compensate for the deficiencies in FAS 5.

Changes in Creditworthiness

Issue 6: This proposed Statement would permit an entity to elect the fair value option for certain financial liabilities, including debt liabilities. Under this proposed Statement, an issuer who has elected the fair value option for its debt liabilities would report changes in fair value of those liabilities, including changes resulting from changes in that issuer's own creditworthiness, as gains and losses in earnings. If significant changes in fair value of those liabilities occur during a period, qualitative disclosures about the nature of those changes would be required. The Board discussed several possible approaches for curtailing the debtor's recognition of the portion of a liability's changes in fair value that is attributable to changes in its own creditworthiness and determined not to

provide any curtailment; instead, the Board decided that liabilities should be recorded at fair value when the fair value option has been elected with all changes in fair value recorded in earnings.

Do you agree with the Board's decision? If not, why not? What alternative approaches or additional disclosure requirements should the Board consider?

We agree with the Board's decision. However, the amount shown for the change in fair value of debt instruments should be separated into the key components, which are illustrated by the following roll-forward of these instruments' balances from the beginning to end of the reported period:

Beginning balance 200X

Cash flows:

- Interest income
- Interest expense
- New borrowings
- Redemptions/settlements
- Maturities

Change in a specified risk-free interest benchmark rate (does not include the change in credit quality)

Change in the effective duration [effective duration is the estimated percentage decline in the portfolio's fair value caused by a one-percentage point increase in interest rates.]

Change in the credit quality [historical default rate used for the change in credit quality]

Change in foreign currency rate(s)

Other (explain what comprises this amount)

Ending balance at 200X

For more elaboration of our view, we have attached the Centre's response to the recent IASB-FASB's survey of users regarding the information about changes in fair values of financial instruments - **Attachment 1**.

We support the IASB's requirement in IAS 32, *Financial Instruments: Disclosure and Presentation*, to require disclosure of the amount of change during the period and cumulatively in the fair value of the instrument that is attributable to changes in credit risk. Consequently, we urge the Board to consider requiring a similar disclosure in its Final standard for the fair value option and eliminate the disclosure difference between the two Standards.

Presentation and Disclosure Requirements

Issue 7: The Board discussed several possible approaches for separately reporting changes in the fair values of financial assets and financial liabilities measured at fair value pursuant to the election of the fair value option in the income statement or in the notes to the financial statements. The Board decided

that an entity should provide information that would allow users to understand the effect of changes in the fair values of assets and liabilities subsequently measured at fair value as a result of a fair value election, but it did not prescribe detailed guidance on where and how that information should be reported.

How should changes in the fair values of assets and liabilities subsequently measured at fair value as a result of a fair value election be reported?

We believe that those financial instruments for which managers have elected to use the fair value option should be shown separately on the face of the balance sheet. The separate display highlights the difference in the measurement attribute, improving the clarity of the information for users of the financial statements. We ***strongly oppose*** the grouping of these financial instruments with other instruments, which are measured differently or “non-fair-value amounts,” and showing parenthetically the amount of the fair value included in the aggregate amount for that line item. This latter presentation simply complicates the accounting and financial reporting by aggregating dissimilar measurement amounts. An investors’ ability to understand financial information is a direct function of ***how*** the information is presented.

Should those changes be aggregated with the effect on earnings derived from other similar financial assets and financial liabilities in the income statement, or should separate display of those changes in the income statement be required? What level of aggregation should be permitted?

Because managers have the discretion to select this measurement option, and to choose which instruments to fair value, we need to understand the effects of these choices on the company’s financial performance and financial condition. Therefore, we believe strongly that the changes in fair values which are attributed to those financial instruments selected under the fair value option should be separated from other changes in fair value. The level of aggregation should be at a portfolio level of financial instruments with similar risk characteristics.

What additional disclosure requirements should the Board consider?

Please refer to our response to ***Issue 6 – Changes in Creditworthiness***, regarding the detailed information provided in our proposed roll-forward of beginning and ending fair value balances and **Attachment 1** which further elaborates on the type of disclosures needed for financial instruments.

Closing Remarks

The CFA Centre for Financial Market Integrity, together with its Corporate Disclosure Policy Council, appreciates the opportunity to provide comments to the FASB regarding the fair value option proposal. If you or your staff have questions or seek further elaboration of our views, please contact Georgene B. Palacky, by phone at +1.434.951.5326 or by e-mail at georgene.palacky@cfainstitute.org.

Sincerely,

/s/ Rebecca T. McEnally

Rebecca T. McEnally, CFA, PhD
Director, CFA Centre

/s/ Georgene B. Palacky

Georgene B. Palacky, CPA
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Our comments have benefited from substantive input of the Corporate Disclosure Policy Council. The members of the Council are:

Patricia A. McConnell, CPA – Chair
Bear, Stearns & Co., Inc.

Jane B. Adams, CPA
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Anthony Good, ASIP
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